EMD: Stronger fundamentals are first line of defence in trade war

While trade tensions have escalated in recent months, we believe the case for emerging markets remains compelling - if investors know where to look.

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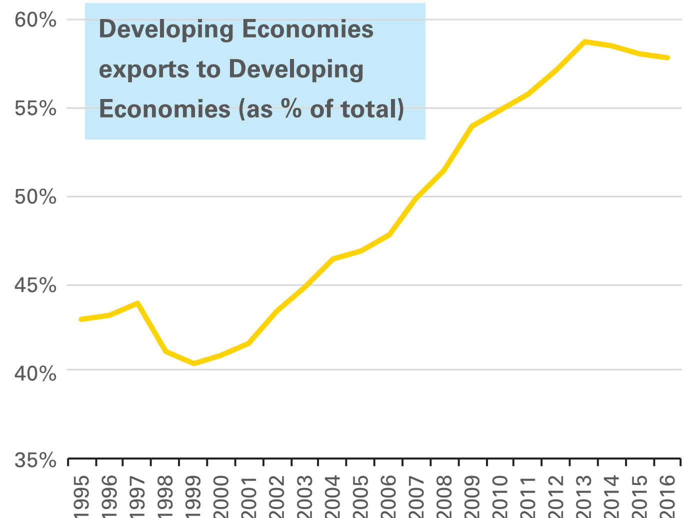
While fears about US protectionism under President Donald Trump largely abated in 2017, trade policy has recently come back under the spotlight. In March, President Trump unveiled the first in a series of promised US tariffs, including a 25% tariff on imported steel, a 10% tariff on imported aluminium and some US$50-60 billion of Chinese imports.

The news has alarmed investors concerned about the impact of a trade war on emerging economies. If trade barriers are attached to a wider range of manufactured products, emerging markets would indeed be materially affected. But in the context of broader regional performance, we believe emerging markets have been able to reduce their vulnerability given their increased interdependence. As Figure 1 demonstrates, more than 55% of "developing economies" exports now go to fellow "developing economies."

Figure 1. EM relies more on EM



Data Source: UNCTAD

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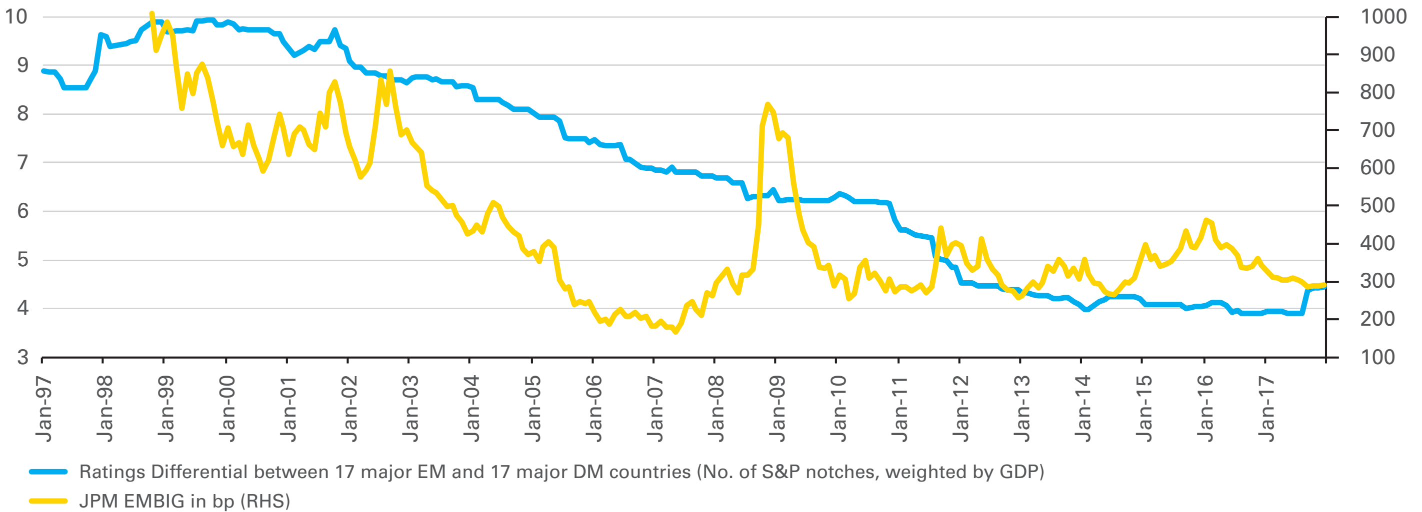
Figure 2. Ratings differential vs. EM Spreads



Data Source: Bloomberg, S&P, IMF WEO

THE EMERGENCE OF EMERGING MARKETS

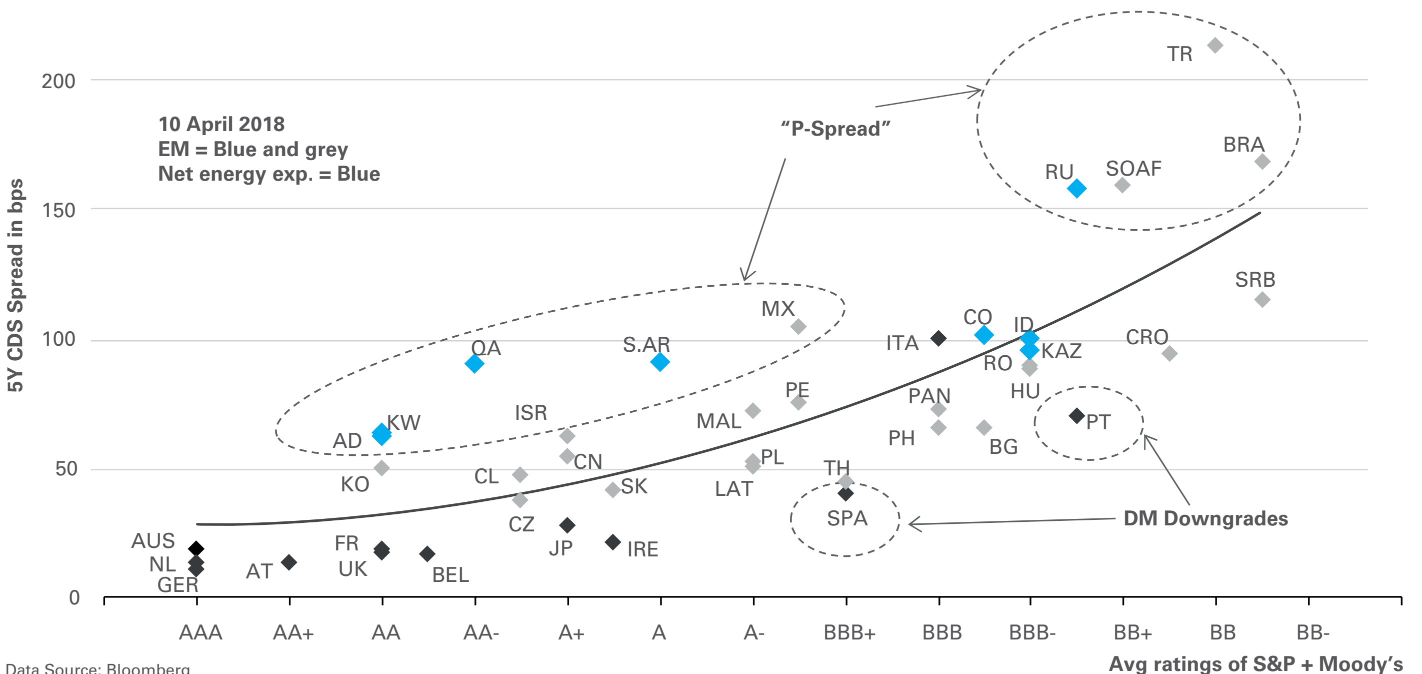
The first question we usually get from investors considering emerging market debt (EMD) is: what about the risks?

To address this question, consider the sovereign credit rating differential between emerging markets and developed markets. As Figure 2 shows, the S&P ratings differential between emerging and developed markets has fallen by around six notches in 20 years, and global spreads have tightened as a result. Compared with peers in advanced economies, the risk picture in emerging markets has improved.

This forms a part of the analysis of the first of two risk types that we consider in our investment process, namely top-down risk, which includes taking into account the spillover from any changes in developed market growth, protectionism, US dollar dynamics, the US treasury curve, and as such, the impact of G3 central bank monetary policy action.

Not only has emerging markets credit risk fallen on a relative basis; developed market risk has also moved higher in the years since the financial crisis. As Figure 3 shows, countries such as Italy, Portugal, Spain and Ireland – which used to be rated AA to AAA – have shifted downwards, while the credit ratings of emerging economies such as China, Chile, Slovakia, and the Philippines have moved up the ratings ladder.

Figure 3. CDS spreads vs. ratings



Data Source: Bloomberg

That is not to say that there aren't any variations in the credit quality of individual emerging markets. This is where the second type of risk steps in: namely idiosyncratic risk, which requires evaluation of 'qualitative' issues of a national dimension, such as corruption, income inequality and national politics and elections (as Figure 3 highlights, the risk appears in the form of what we call the P-Spread or 'political spread').

PICKING OUT THE WINNERS

The shift in creditworthiness in emerging markets aligns with increasingly prudent central bank activity, relatively careful public sector spending and improving GDP growth. In the 1980s, emerging economies contributed 30% to global GDP growth, developed economies, 70%. This picture has now reversed, with emerging economies contributing 70% and developed economies only 30% to growth[1]. As a result of the divergence, emerging markets have increased their geopolitical significance: another reason why developed market protectionism may ultimately be blunted.

But while emerging markets growth is picking up on the whole, the growth outlook is still highly differentiated amongst regions. It is, in short, not enough for investors to just plug into emerging markets on whim – idiosyncratic risk remains in key spread areas. This is why we believe the year ahead is going to be about finding opportunities among the idiosyncrasies.

We use quantitative and qualitative models developed in-house to analyse credit risks among different emerging markets. South Africa, for example, stands out as having very high youth unemployment and income inequality, with growth and productivity negatively influenced. The dependency ratio versus median age ratio is another useful way of assessing future challenges for a sovereign's fiscal budget and long-term economic growth potential. Indeed, countries with a low dependency and median age mix – such as India and Sub-Saharan Africa – often experience higher economic growth rates.

DIFFERENTIATION - A KEY THEME

While emerging markets remain vulnerable in the short term to any pick-up in US protectionism, their increased interdependence provides a buffer, as does the relative improvement in emerging market versus developed market fundamentals over the past years. Nonetheless, differentiation will remain a key theme this year in emerging markets as the 70 or so countries in the Emerging Markets Bond Index Global Diversified (EMBIGD) face varying degrees of exposure not only to US protectionism but also to a tightening of G3 monetary policy.

1. Data source: IMF WEO

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